United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

signed

77-4179

B
P/S

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

WILLIAM J. McDONALD, SR., and ELIZABETH J. McDONALD,

Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT

M. CARR FERGUSON,
Assistant Attorney General,

GILBERT E. ANDREWS,
WILLIAM S. ESTABROOK,
THOMAS M. WALSH,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

UNITED STATES COURT OF APPEALS
FILED
DEC 21 1977
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

TABLE OF CONTENTS

	Page
Statement of the issue presented	1
Statement of the case	1
Summary of argument	6
Argument:	
The Tax Court erred in concluding that the taxpayer was entitled to a business expense deduction under Section 162 of the Internal Revenue Code of 1954 for $121,400, the amount which he repaid to the heirs of an estate in compromise of a will contest	7
A. The Tax Court applied an erroneous legal standard in basing its allowance of the deductibility of such expenditure upon the taxpayer's primary purpose in making the expenditure	7
B. The expenditure is not deductible as a business expense because it arose out of a will contest, and not out of the taxpayer's business or profit-seeking activities	11
C. The expense is likewise nondeductible since it was not an expense incurred by the taxpayer, and, if it was, it was incurred to obtain a tax-free legacy	16
Conclusion	19
Appendix	20

CITATIONS

Cases:

Anchor Coupling Co. v. United States, 427 F. 2d 429 (C.A. 7, 1970)	10,11,12
Bear Gulch Water Co. v. Commissioner, 116 F. 2d 975 (C.A. 9, 1941)	17
Bell v. Commissioner, 320 F. 2d 953 (C.A. 8, 1963)	10
Bettendorf v. Commissioner, 49 F. 2d 175 (C.A. 8, 1931)	17
Bonney v. Commissioner, 247 F. 2d 237 (C.A. 2, 1957)	10

FORMERLY DJ-152 FORM DOJ-152
8-20-75

Page

Cases (continued):

Clapp v. United States, 364 F. 2d 425 (Ct. Cl., 1966) ---------- 10
Clark Oil and Refining Co. v. United States, 473 F. 2d 1217 (C.A. 7, 1973) ---------- 10
Commissioner v. Burgwin, 277 F. 2d 395 (C.A. 3, 1960) -- 18
Commissioner v. Heininger, 320 U.S. 467 (1943) --------- 14
Decatur Water Supply Co. v. Commissioner, 88 F. 2d 341 (C.A. 7, 1937) ---------- 17
Deputy v. DuPont, 308 U.S. 488 (1940) ---------- 8,9
Ditmars v. Commissioner, 302 F. 2d 481 (C.A. 2, 1962) ---------- 15
Draper v. Commissioner, 26 T.C. 201 (1956) ---------- 15
Estate of Meade v. Commissioner, 489 F. 2d 161 (C.A. 5, 1974) ---------- 11
Fischer v. United States, 490 F. 2d 218 (C.A. 7, 1973) ---------- 16
Grabien v. Commissioner, 48 T.C. 750 (1967) ---------- 18
Helvering v. Community Bond & Mortgage Corp., 74 F. 2d 727 (C.A. 2, 1935) ---------- 12
Holt v. Commissioner, 313 U.S. 28 (1941) ---------- 17
Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943) ---------- 8
Iowa Southern Utilities v. Commissioner, 333 F. 2d 382 (C.A. 8, 1964) ---------- 10
Jim Walter Corporation v. United States, 498 F. 2d 631 (C.A. 5, 1974) ---------- 11
Kehoe v. Commissioner, 27 T.C.M. 1162 (1968) ---------- 18
Keokuk & Hamilton Bridge v. Commissioner, 180 F. 2d 58 (C.A. 8, 1950) ---------- 17
Kornhauser v. United States, 276 U.S. 145 (1928) ------- 9
Levitt & Sons v. Nunan, 142 F. 2d 795 (C.A. 2, 1944) ---------- 12
Lewis v. Commissioner, 253 F. 2d 821 (C.A. 2, 1958) ---- 10,12,14
Lykes v. United States, 343 U.S. 118 (1952) ---------- 9,14
Madden v. Commissioner, 514 F. 2d 1149 (C.A. 9, 1975) -- 11
Marks v. Commissioner, 390 F. 2d 598 (C.A. 9, 1968) ---- 18
McKee v. Commissioner, 19 B.T.A. 430 (1930) ---------- 17
Nadiak v. Commissioner, 356 F. 2d 911 (C.A. 2, 1966) --- 10,12,15
New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934) ---------- 8
Omaha Public Power District v. O'Malley, 232 F. 2d 805 (C.A. 8) cert denied, 352 U.S. 837 (1956) -------- 17
Ransburg v. United States, 440 F. 2d 1140 (C.A. 10, 1971) ---------- 10
Scheefer v. Commissioner, 25 T.C.M. 474 (1966) --------- 18
United States v. Gilmore, 372 U.S. 39 (1963) ---------- 9,12
United States v. Hilton Hotels, 397 U.S. 580 (1970) ---- 11
Woodward v. Commissioner, 397 U.S. 572 (1970) ---------- 11,12

Page

Statutes:

Internal Revenue Code of 1954 (28 U.S.C.):
Sec. 102 ---------- 18,20
Sec. 162 ---------- 5,20

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 77-4179

WILLIAM J. McDONALD, SR., and ELIZABETH J. McDONALD,

Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT

STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court erred in concluding that the taxpayer was entitled to a business expense deduction under Section 162 of the Internal Revenue Code of 1954 for $121,400, the amount which he repaid to the heirs of an estate in compromise of a will contest.

STATEMENT OF THE CASE

This case is an appeal from the decision (R. 40)[1] of the Tax Court (Chief Judge Dawson) that the taxpayer, William J. McDonald,[2] owed no further taxes

1/ "R." references are to the separately bound record appendix.

2/ Mr. McDonald's wife, Elizabeth J. McDonald, is also a party only because she signed the joint returns with her husband.

for the years 1970 through 1973, contrary to the determination of the Commissioner of Internal Revenue that taxpayer owed $33,939.60 in income taxes for those years.[3/] The Tax Court's memorandum opinion (R. 27-39), which is reported at P-H Memo T.C., par. 77,202, was filed on June 29, 1977. The Commissioner filed a notice of appeal to this Court on September 28, 1977. Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954 (26 U.S.C.).

The case was submitted without trial (R. 5), based upon stipulated facts (R. 8-26) which can be su marized as follows:

On February 28, 1972, Mrs. Hazel A. Leckie died. (R. 9.) Her will (R. 14-16), as changed by a codicil,[4/] bequeathed specific items of personal property, such as paintings, jewelry and furs, to certain relatives and to the taxpayer and his wife (R. 14); it left the residue of the estate to the taxpayer or, in the event he predeceased Mrs. Leckie, to his wife (R. 15). It also named the taxpayer as executor of the will and named his wife as the alternate executor. (Ibid.)

In listing the specific bequests, the will named the recipients and identified them by their connection with Mrs. Leckie, thus identifying the relatives as such, as well as identifying the taxpayer as "my friend, WILLIAM J. McDONALD, an attorney of Geneva, New York" (R. 14) and his wife as "my friend, ELIZABETH J. McDONALD, wife of said attorney." (Ibid.) In bequeathing the residue of the estate to the McDonalds,

---

3/ The Commissioner determined the following deficiencies: 1970, $6,813.40; 1971, $8,380.37; 1972, $1,229.83; 1973, $17,516.(R. 28.)

4/ The codicil (R. 17-18) revoked a single specific request to "my employee of many years service, ROSE CONTINI." (R. 14.) The codicil, but not the will, was drafted by the taxpayer. (R. 9.)

Mrs. Leckie declared in her will (R. 15)--

> I wish to specifically state herein that my reason for the bequest of my residuary estate as hereinabove provided is that said William J. McDonald and his said wife have been consistently faithful, both in the affairs of Walter Rose [her husband] and myself, over a period of years, whereas my other relatives and friends have not given me any valued attention whatsoever.

Finally, in appointing the taxpayer to execute her will, Mrs. Leckie again referred to him as "my said friend." (Ibid.)

When the will was offered for probate, Mrs. Leckie's relatives raised objections, alleging that the bequests to the taxpayer and his wife had not been freely made by Mrs. Leckie, but had been procured by the taxpayer's exertion of undue influence over Mrs. Leckie. (R. 9-10.) These objections were subsequently withdrawn, because the taxpayer and the relatives executed a compromise agreement, and the will was admitted to probate. (R. 31-32.) The compromise agreement (R. 19-21) was reached, in part, because full litigation of the relatives' claims apparently would have caused publicity[5/] and endangered the taxpayer's reputation. (R. 32.) That agreement provided that the relatives would withdraw their objections in exchange for payments of money from the taxpayer, including one-half of the principal of a trust fund. (R. 20-21.)

5/ The only record evidence of bad publicity was two articles from local newspapers (Joint Exs. 10-J and 11-K, not included in record appendix) which dealt with the taxpayer's disagreement with the Internal Revenue Service.

On April 12, 1973, the taxpayer filed a petition for an order approving compromise of the controversy (R. 22-26) with the Surrogate's Court having jurisdiction to probate the will (R. 32). The petition urged the court to approve the compromise, asserting that protracted litigation would cause publicity and endanger the taxpayer's reputation and would delay the settlement of the estate and diminish its value. (R. 25.) On April 23, 1973, the court approved the compromise agreement, authorizing the taxpayer to make payments to the relatives out of the principal of the estate. Thereafter, the taxpayer paid them $121,400, "which he had received under the residuary clause of the last will and testament of Hazel A. Leckie." (R. 10, 11.)

On his Federal income tax return for 1973, the taxpayer claimed a deduction of $121,400 for "preservation of reputation." (R.11,33.) He then applied for refunds for the years 1970 through 1972, claiming that a net operating loss carryback from 1973 resulted from that claimed deduction. (R. 12.) The Commissioner of Internal Revenue first allowed the refund, but then disallowed the deduction for 1973 and thus disallowed the loss carryback and the refund for the three earlier years. (Ibid.) The Commissioner determined that a deficiency existed for the years 1970 through 1973, and the taxpayer petitioned the Tax Court for a redetermination that no deficiency existed. (R. 1-4.)

On June 30, 1977, the Tax Court rendered its decision (R. 40) based on the stipulated facts, pursuant to Rule 122 of its Rules of

Practice and Procedure. Observing that the stipulation provided "minimal information" (R. 33), the Court nonetheless determined that the taxpayer was entitled to deduct all the payments made to the relatives. (R. 39, 40.) Finding that, in addition to the friendship between the taxpayer and Mrs. Leckie, there was an attorney-client relationship, that the relatives' claims of "undue influence" were potentially damaging to the taxpayer's reputation, and that the taxpayer settled those claims in order to avoid publicity, the Court reasoned that the taxpayer's "primary purpose for settling those claims was to protect his business reputation and his future earnings flow" and that the taxpayer's personal considerations "were incidental to his desire to protect his business." (R. 36-37.) The Court thus concluded that the payments for "preservation of reputation" were fully deductible under Section 162 of the Internal Revenue Code of 1954 (26 U.S.C.), as ordinary and necessary business expenses.

On September 28, 1977, the Commissioner filed a notice of appeal from that decision.

SUMMARY OF ARGUMENT

The taxpayer has failed to show that the payments to Mrs. Leckie's relatives were ordinary and necessary business expenses. The record shows only that the taxpayer made the payments because he feared that litigation contesting Mrs. Leckie's will would injure his reputation and that such injury would damage his business, the practice of law. It is well settled, however, that it is the origin of a claim, not the taxpayer's purpose for paying it, which determines whether the payments are deductible. The record clearly demonstrates that the claim against the taxpayer originated in the relatives' challenge to the will, not in an attack upon the taxpayer's business, such as a malpractice suit would be. It is irrelevant that the taxpayer settled the claims in order to protect his reputation from adverse publicity.

In relying upon the taxpayer's purpose in paying the claims, the Tax Court applied an incorrect legal test for determining whether payments are directly related to a taxpayer's business. Under the correct "origin of the claim" test, it is clear that the payments were not directly related to the taxpayer's business, his law practice; instead, they originated in the relatives' challenge to the will, an event not arising out of the taxpayer's business. This application of the "origin of the claim" test also promotes the ends intended by that test, the elimination of subjective considerations to avoid capricious results and to

achieve uniformity and consistency in the application of the tax laws.

Further, taxpayer's attempt to obtain a tax deduction for the amount returned by him to the estate, and thence to the other heirs, should be rejected, since he was merely returning what did not belong to him. He is no more entitled to a tax deduction for returning an asset which he anticipated receiving, but did not, in fact, receive, than is any other taxpayer entitled to a deduction for anticipated income which the taxpayer failed to realize. Moreover, as an expense incurred to obtain a tax-free legacy is not income, so too sharing a legacy with a claimant should not give rise to a deduction in the amount of the surrendered share that will simply shelter other taxable income which the taxpayer has received.

ARGUMENT

THE TAX COURT ERRED IN CONCLUDING THAT THE TAXPAYER WAS ENTITLED TO A BUSINESS EXPENSE DEDUCTION UNDER SECTION 162 OF THE INTERNAL REVENUE CODE OF 1954 FOR $121,400, THE AMOUNT WHICH HE REPAID TO THE HEIRS OF AN ESTATE IN COMPROMISE OF A WILL CONTEST

A. The Tax Court applied an erroneous legal standard in basing its allowance of the deductibility of such expenditure upon the taxpayer's primary purpose in making the expenditure

Section 162(a) of the Internal Revenue Code of 1954, Appendix, infra, provides, in pertinent part, as follows:

> In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

The Treasury Regulations promulgated thereunder state that deductible expenses are those "directly connected with or pertaining to the taxpayer's trade or business." Treasury Regulations on Income Tax (1954 Code), §1.162-1(a) (26 C.F.R.). The taxpayer has the burden of establishing his right to such a deduction. Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943); Deputy v. DuPont, 308 U.S. 488, 493 (1940); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934).

The taxpayer in this case asserts that he is entitled to a business expense deduction of $121,400, representing the amount which he returned to Mrs. Leckie's heirs in settlement of the latters' will contest suit, in which the taxpayer's undue influence on the deceased was alleged. The taxpayer urges, and the Tax Court found (R. 37), that this expenditure qualified as a business expense deduction under Section 162 of the Code, because the taxpayer's "primary purpose for settling those claims was to protect his business reputation and his future earnings flow." While this contention may have received unwarranted impetus from the Commissioner's trial brief, which did engage in some lengthy dispute over taxpayer's exact

motivation in settling the suit,[6/] in fact the taxpayer's motivation in making a payment is legally irrelevant in determining the deductibility of such expenditures as a Section 162 business expense.

Thus, in United States v. Gilmore, 372 U.S. 39 (1963), a taxpayer sought to deduct expenses incurred in a divorce proceeding, alleging, inter alia, that the expenditures were necessary to disprove his wife's allegations of his marital infidelity, allegations which, if allowed to persist unchallenged, would have harmed his reputation and might have caused revocation of his automobile franchise. The court, relying upon earlier cases which had concentrated upon the origin of the claim which resulted in the accrual of the expense, in determining the deductibility of such expense (Deputy v. DuPont, 308 U.S. 488, 494, 496 (1940); Lykes v. United States, 343 U.S. 118, 123 (1952); and Kornhauser v. United States, 276 U.S. 145, 153 (1928), concluded that (372 U.S., p. 48) deductibility--

---

6/ The Commissioner contended that the taxpayer's motive in settling the suit was primarily personal. Although the Commissioner considers it somewhat ironic that the taxpayer, who received no notable publicity of any sort as a result of the will contest suit, should assert a fear of adverse publicity from failure to settle the will contest and at the same time bring a suit regarding deductibility of expenditures made in connection with that will contest which did in fact receive widespread publicity (Joint Exs. 10-J and 11-K), for purposes of this appeal, he accepts the Tax Court's finding that the taxpayer's motivation in settling the lawsuit was to protect his business reputation.

> depends on whether or not the claim arises in connection with the taxpayer's profit-seeking activities. It does not depend on the consequences that might result from a failure to defeat the claim * * *. [Emphasis in original.]

After noting that a test depending upon the consequences of a failure to incur the expenditure in question would tend to produce capricious results, the court concluded (372 U.S., p. 49) that--

> the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was "business" or "personal" and hence whether it is deductible or not under §23(a)(2) [the predecessor of Section 212(1) of the Internal Revenue Code of 1954].

This analysis, which was presaged by this Court's reasoning in Lewis v. Commissioner, 253 F. 2d 821, 825 (1958), and its holding in Bonney v. Commissioner, 247 F. 2d 237 (1957), has subsequently become firmly established as the appropriate test in determining the deductibility of particular expenditures, under both Sections 162 and 212 of the Code. See, e.g., Bell v. Commissioner, 320 F. 2d 953 (C.A. 8, 1963); Iowa Southern Utilities v. Commissioner, 333 F. 2d 382 (C.A. 8, 1964); Clapp v. United States, 364 F. 2d 425 (Ct. Cl., 1966); Nadiak v. Commissioner, 356 F. 2d 911 (C.A. 2, 1966); Anchor Coupling Co. v. United States, 427 F. 2d 429 (C.A. 7, 1970); Ransburg v. United States, 440 F. 2d 1140 (C.A. 10, 1971); Clark Oil &

Refining Co. v. United States, 473 F. 2d 1217 (C.A. 7, 1973); Estate of Meade v. Commissioner, 489 F. 2d 161 (C.A. 5, 1974); Jim Walter Corp. v. United States, 498 F. 2d 631 (C.A. 5, 1974); Madden v. Commissioner, 514 F. 2d 1149 (C.A. 9, 1975). And see Woodward v. Commissioner, 397 U.S. 572 (1970) and United States v. Hilton Hotels, 397 U.S. 583 (1970), holding that whether expenditures incurred in the course of stock appraisal proceedings are deductible or capitalizable necessitates an examination of whether the origin of the claim being litigated arose in the process of acquisition, and not the taxpayer's purpose in bringing, or defending the suit, a test which the court found would encourage a resort to formalisms and artificial distinctions. As the Seventh Circuit in Anchor Coupling Co. v. United States, 427 F. 2d, p. 433 (1970) noted, the "origin of the claim" test for determining whether expenses are proximately related to a business is an objective test which supplants the subjective "primary purpose" test, and thus, in avoiding the capricious results which occur under the subjective test, promotes "uniformity in the application of our tax laws."

B. The expenditure is not deductible as a business expense because it arose out of a will contest, and not out of the taxpayer's business or profit-seeking activities

The Tax Court decided that the payment of $121,400 was directly connected with the taxpayer's business because, it reasoned, the taxpayer's "primary purpose" for paying off the relatives was "to protect his business reputation and his

future earnings flow." (R. 37.) It supported its decision by citing two pre-Gilmore cases, Levitt & Sons v. Nunan, 142 F. 2d 795 (C.A. 2, 1944) and Helvering v. Community Bond & Mortgage Corp., 74 F. 2d 727 (C.A. 2, 1935), which examined the taxpayers' motives for making certain payments. As observed in Anchor Coupling, supra, the subjective "primary purpose" test is incompatible with the objective "origin of the claim" test of Gilmore, supra, and Woodward, supra, so the latter is now the only proper test for determining whether a taxpayer's expenses are sufficiently related to his business to be deductible. Accord, Lewis v. Commissioner, supra; Nadiak v. Commissioner, supra. Thus, in relying upon the taxpayer's purpose for settling the will contest, the Tax Court erred, and its decision is accordingly flawed.

The record clearly shows that the "origin of the claim" against the taxpayer was not related to his business, since it arose from the will contest, so the settlement payments are not deductible as business expenses. The claim against the taxpayer originated in the relatives' challenge to the will. That challenge could not be construed as an attack upon the taxpayer's professional ability, because he had not drawn the will. The will did not purport to compensate the taxpayer for the occasional professional services rendered to Mrs. Leckie, so his settlement of the will

contest was not a means of securing compensation for professional services. Moreover, there is no evidence that the relatives instituted the will contest to discredit the taxpayer professionally. If they had, they would have proceeded differently, e.g. seeking his disbarment or suing for malpractice, and they would have persisted, rather than quickly settling the case. The fact that there was no apparent basis for such proceedings emphasises the non-business nature of their claims and the settlement. The will contest, therefore, did not arise from the taxpayer's law practice. In this light, whether the alleged undue influence was founded upon assumptions that the taxpayer took advantage of Mrs. Leckie through his and his wife's friendship with her, or through his sometime relationship as her attorney, is clearly an irrelevancy.

However, the facts in this case suggest that, to the extent that inquiry is a relevant one,[7/] the objectants' claim attacked only Mrs. Leckie's bequests to her friends, the taxpayer and his wife. As the will itself evidences, the bequests arose from the friendship which existed between Mrs. Leckie and the taxpayer and his wife. The will left the residue of her estate not to the taxpayer alone, but to the taxpayer and his wife, should the taxpayer predecease Mrs. Leckie. Further, the will carefully specified that the taxpayer and his wife were favored over the relatives because of their long and faithful friendship with Mrs. Leckie and her late husband, which contrasted strongly, in

7/ Neither party deposed the objectants, and the objections themselves are not a part of this record.

the decedent's eyes, with the relatives total inattention. (R. 15.) Nothing in the record, on the other hand, demonstrates that the objectants knew of the taxpayer's legal relationship with Mrs. Leckie, such as it was.[8/] The will merely identified the taxpayer as an "attorney" and "friend".

This case, then, is similar to other cases decided by this Court and others, in which deductions were disallowed. Thus in Lewis v. Commissioner, supra, this Court held that an amount expended by the taxpayer, a writer, for legal fees in defending against i competency proceedings brought by his wife were non-deductible personal expenses, despite the taxpayer's assertion that "the publicity attendant upon an adjudication of mental incompetency would have been extremely detrimental" to his business as a writer. This Court distinguished situations such as appeared in Commissioner v. Heininger, 320 U.S. 467 (1943), in which legal expenses were found to be deductible where they were made in defending against a direct attack upon the taxpayer's profit-seeking activities [in that case, a suit resisting the Postmaster's order prohibiting his allegedly improper use of the mails], and ruled (253 F. 2d, 825) that

> Determination of the deductibility of an item of expense surely depends upon the activity in connection with which the item was expended and to which it relates, Lykes v. Commissioner, 343 U.S. 118 (1952); yet, when the activity has been determined, one must then determine the nature of that activity in order to discover if the item may be deducted.

8/ The Record indicates a single instance of the taxpayer performing legal services for Mrs. Leckie, the drafting of the minor codicil. (R. 9.)

FORMERLY DJ-152 FORM DOJ-152
8-20-79

Accordingly, this Court, after rejecting the "primary purpose" rationale in Draper v. Commissioner, 26 T.C. 201 (1956), relied upon by the taxpayer in the proceedings below (taxpayer's Reply Brief, p. 4), concluded that expenses incurred in defending against charges directed against him as a person were nondeductible personal expenses, because the charges were not "directed to his occupational activities as such." Again, in Nadiak v. Commissioner, supra, this Court held that a taxpayer, an airline pilot, was not entitled to deduct legal fees expended in defense of criminal proceedings instituted at the behest of his former wife, despite the taxpayer's assertion that conviction would have resulted in revocation of his pilot's license. This Court emphasized that the origin of the legal expenses lay in the criminal charges which "arose in connection with the apparently exacerbated relationship between him and his former wife." (356 F. 2d, p. 912.) Citing Gilmore, this Court held (Ibid.):

> The origin of the legal expenses was thus personal, only the potential consequences of the criminal proceedings posed a threat to the petitioner's fortunes. According to the Supreme Court the deductibility vel non of the costs of resisting a claim turns on whether the claim arose in connection with the taxpayer's profit-seeking activity rather than on the potential consequences of failing to defend. [emphasis in original]

And see Ditmars v. Commissioner, 302 F. 2d 481, 487 (C.A. 2, 1962), where this Court stated:

> To such extent as litigation springs solely from the taxpayer's non-business life, expenses of defending or settling it are

FORMERLY DJ-152 FORM DOJ-152
8-20-75

> "personal" expenses whose deduction is forbidden by §262, even though the litigation might be detrimental to the taxpayer's profit-seeking activities.

In another case, Fischer v. United States, 490 F. 2d 218 (C.A. 7, 1973), the taxpayer was in an even stronger position, yet he was still denied a deduction. He was a corporation president who sought to deduct expenses incurred in inducing certain debenture-holders to settle a controversy which, the corporation's board of directors suspected, resulted from his negligent performance of his duties. The Court concluded that the disgruntled debenture holders' suit would have been against the corporation, not its president, so it held that the president's expenses were not deductible, even though the suit would have resulted from his alleged negligence in performing his official duties and would have clearly endangered his reputation and his job. Similarly, here the relatives' suit was against the will, not against the taxpayer, although it alleged his "undue influence" and incidentally threatened his professional standing. Those underlying allegations are too remote from his business to permit a business deduction for his settlement payments.

C. The expense is likewise nondeductible since it was not an expense incurred by the taxpayer, and, if it was, it was incurred to obtain a tax-free legacy

In addition, since the taxpayer settled the will contest by disgorging money received from the estate which was not really

his, he incurred no expense at all. The taxpayer's right to receive the assets of Mrs. Leckie's estate was contingent upon his paying $121,400 to the relatives; the Surrogate's Court's order allowed him to satisfy that obligation from the principal of the estate.[9/] That portion of the estate, therefore, never inured to his benefit, and he merely acted as a conduit or agent[10/] to transfer part of the estate to the relatives automatically. Since the taxpayer never really owned that portion of the estate, he cannot have expensed it, McKee v. Commissioner, 19 B.T.A. 430 (1930), just as losses deductible under Section 165 do not include the failure to receive anticipated income. Holt v. Commissioner, 313 U.S. 28, 32-33 (1941). Indeed, it is not certain that the taxpayer actually received the $121,400 for his own use before transferring that amount.[11/] In any event,

---

9/ The Court ordered (Appendix):

> *** that said compromise agreement dated December 19, 1972, be and the same is in all respects approved, sanctioned and ratified; and the said William J. McDonald, individually and as such executor is hereby authorized to adjust such controversy by such compromise, and to make payments out to the principal of the estate ***

10/ Keokuk & Hamilton Bridge v. Commissioner, 180 F. 2d 58-62 (C.A. 8, 1950); also see, Bettendorf v. Commissioner, 49 F. 2d 173 (C.A. 8, 1931), and Decatur Water Supply Co. v. Commissioner, 88 F. 2d 341 (C.A. 7, 1937), and compare, Omaha Public Power District v. O'Malley, 232 F. 2d 805 (C.A. 8), cert. denied, 352 U.S. 837 (1956) and Bear Gulch Water Co. v. Commissioner, 116 F. 2d 975 (C.A. 9, 1941).

11/ The Record states that the taxpayer "paid the sum of $121,400, which he had received under the residuary clause," which suggests that he received it as beneficiary, and not merely as executor. Yet, the phrase is sufficiently ambiguous to interpret the actions as those of an executor authorized by court order to make payments out of the estate's principal.

regardless of the capacity in which taxpayer received the money, he had no right to retain it; so transferring it to the relatives was no expense.[12/] See Marks v. Commissioner, 390 F. 2d 598 (C.A. 9, 1968).

Moreover, since it is clear that under Section 102 of the Internal Revenue Code of 1954, Appendix, infra, the legacy which the taxpayer did in fact ultimately receive was excluded from his gross income, whatever expenses were incurred to obtain such legacy are not deductible from income. Commissioner v. Burgwin, 277 F. 2d 395 (C.A. 3, 1960); Grabien v. Commissioner, 48 T.C. 750 (1967); Kehoe v. Commissioner, 27 T.C.M. 1162 (1968). Cf. Section 265(1) of the Internal Revenue Code of 1954, Appendix, infra, disallowing the deductibility of expenditures allocable to tax-exempt income. This being the case, it would seem a fortiori true that sharing a legacy with a claimant should not give rise to a deduction in the amount of the surrendered share that will simply shelter other taxable income which the taxpayer has received. Cf. Scheefer v. Commissioner, 25 T.C.M. 474 (1966).

12/ The lack of merit in the taxpayer's case is demonstrated by considering the tax consequences of another avenue which was open to the taxpayer. If the taxpayer had determined to accept none of the bequests under the will, assuredly he would be entitled to no income tax deduction as a result of that choice. That being so, it is difficult to fathom how the taxpayer may obtain an income tax deduction when he accepts only one-half.

CONCLUSION

The decision of the Tax Court should be reversed.

Respectfully submitted,

M. CARR FERGUSON,
Assistant Attorney General,

GILBERT E. ANDREWS,
WILLIAM S. ESTABROOK,
THOMAS M. WALSH,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

DECEMBER, 1977.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on appellee, appearing pro se, by mailing four copies thereof to him on this 19th day of December, 1977, in an envelope, with postage prepaid, properly addressed to him as follows:

William J. McDonald, Sr., Esquire
Bond, McDonald & Toole
P. O. Box 228
Geneva, New York 14456

/s/ Gilbert E. Andrews
GILBERT E. ANDREWS,
Attorney.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 102. GIFTS AND INHERITANCES.

(a) General Rule.--Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

(b) Income.--Subsection (a) shall not exclude from gross income--

(1) the income from any property referred to in subsection (a); or

(2) where the gift, bequest, devise, or inheritance, the payment, crediting, or distribution thereof is to be made at intervals, then, to the extent that it is paid or credited or to be distributed out of income from property, it shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property. Any amount included in the gross income of a beneficiary under subchapter J shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property.

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) [as amended by Sec. 4(b), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960].
In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including the entire amount expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, Territory, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000.

At a Surrogate's Court held in and for the County of Ontario at the Surrogate's Office in the City of Canandaigua, New York on the 23 day of April, 1973.

PRESENT: Hon. JOSEPH W. CRIBB,

Surrogate.

SURROGATE'S COURT COUNTY OF ONTARIO

In the Matter of the Application for an Order Approving the Compromise of a Controversy Arising in the Estate of

HAZEL A. LECKIE. Deceased.

ORDER

On reading and filing the petition of William J. McDonald, verified 12th day of April, 1973, praying for the approval and sanction by this Court of a certain agreement of compromise in writing, dated the 19th day of December, 1972, executed by the petitioner individually and as executor of the estate of Hazel A. Leckie, deceased and by Jean Kauffman, Andrew F. Leckie, Ethel Larsen, John Albright, Clarence Albright, Ida May Mosher, Mary E. Olszewske, Donald E. Sheridan, Lillian F. Rapp and Earl R. Sheridan, all of the persons interested in the estate of said deceased and in this proceeding, who claim a portion of the estate of Hazel A. Leckie; which said agreement was made and executed for the purpose of adjusting by compromise a controversy arising over the probate of the Last Will and Testament and Codicil of the said Hazel A. Leckie, deceased.

Now, on motion of Bond, McDonald and Toole, William J. McDonald of counsel, and with the consent of all the parties to the said agreement, and in the interest of the estate and all parties as above set forth, it is

DKT NO. 5140-74
Joint EXH. 9-I

BOOK 334 PAGE 587

D-

ORDERED, that said compromise agreement dated December 19, 1972, be and the same is in all respects approved, sanctioned and ratified; and the said William J. McDonald, individually and as such executor is hereby authorized to adjust such controversy by such compromise, and to make the payments out of the principal of the estate of said deceased, to Jean Kauffman, Andrew F. Leckie, Ethel Larsen, John Albright, Ida May Mosher, Mary E. Olschewske, Donald E. Sheridan, Lillian F. Rapp and Earl R. Sheridan upon the terms and conditions and as provided in said compromise agreement, and it is further

ORDERED that the compensation of Bonney & Nicit, Robert J. Roulan, Frederick M. Hunt, Vorys, Sater, Seymour and Pease, attorneys for all of the respondents is fixed at twenty-five (25%) percent of the net amount to be paid to said respondents and that said compensation be paid by the respondents to said attorneys from the monies received by them, and it is further

ORDERED that The Huntington National Bank of Columbus, Ohio pay to William J. McDonald, upon receipt of a copy of this order, all of the sums in their hands belonging to the estate of Hazel A. Leckie and it is further

ORDERED that the Compromise Agreement and all other papers pertaining to this proceeding shall be sealed and shall not be subject to access or inspection except by order of the Surrogate for good cause shown and on notice to William J. McDonald.

Joseph H. Tribbe
Surrogate

DATED: April 23, 1973.

ENTER.